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POLICY MATTERS

The Sequester

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*In this Q&A, **John L. Bellows, PhD and Investment Management Strategy Analyst,** discusses the sequester, its distribution across government programs, how it may affect the economy, how it is reflected in economic forecasts, and what both the sequester and a possible government shutdown later in March might mean in terms of the US credit rating.*

Q: What is the sequester?

JB: The sequester is an across-the-board spending cut to certain US federal government programs. The sequester will reduce US federal government spending authority by $85 billion through the remainder of CY2013. Because there is a delay between when a reduction in authority shows up as a reduction in outlays, the change in government spending due to the sequester will be a somewhat smaller $64 billion through the remainder of CY2013. The sequester officially went into effect on March 1. Congress has the authority to reduce, reallocate, or defer the sequester, but the prospects for any such changes are uncertain.

Q: Why is the sequester unpopular?

JB: The sequester is deeply unpopular among Washington policymakers, but for different reasons on each side of the aisle. Republicans are concerned about the large cuts to defense. Democrats are concerned about both the timing of the cuts (they would rather have spending cuts "back-loaded," or take effect a few years from now) and about cuts to domestic priorities, such as government funding for medical research and development.

Deficit hawks do not consider the sequester an effective way to reduce deficits. The sequester focuses all of the spending cuts on a relatively small part of the budget (the impacted programs account for less than ½ of total spending) and, moreover, this part of the budget has already been cut multiple times since 2008. Most importantly, the sequester does not address rising health care expenditures, which are the primary driver of long-run deficits.

Q: How is the sequester distributed across governmental programs?

JB: Half of the cuts are to defense programs. The impacted defense programs will be cut by approximately 10%. The other half of the cuts are to non-defense programs, primarily non-defense discretionary programs. The impacted non-defense programs will be cut by approximately 7.5%. A number of programs are exempt from the sequester, including Social Security, safety net programs (Medicaid, food stamps, etc.), active duty military pay, and war funding. There will be some cuts to Medicare, but they are limited to only 2% by program[1].

1 Some more details: Starting in FY2014 the sequester will be implemented by lowering the caps on total defense and non-defense discretionary spending. Congress will then have discretion to decide the allocation of funds to specific programs, as long as the total amount allocated remains under the cap. FY2013 is different, in part because the cuts take place in the middle of the fiscal year. In FY2013 the sequester reduces the authority for every affected program by a pre-determined percentage, hence the "across-the-board" nature of the cuts. Congress could choose to reallocate the cuts in order to protect some programs, but this would require a proactive step.

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Q: When will the impact be felt on the economy?

JB: When the sequester took effect on March 1, there was a discrete change in government spending authority. However, this is unlikely to translate into a discrete change in actual outlays for a few reasons. First, as mentioned above, there is a usual lag between a change in spending authority and the change in outlays. For example, if the cuts cause a particular program to reduce its purchases of equipment (think defense equipment), then the first step is that the account manager will cancel any ongoing processes to initiate new contracts, rather than stopping payments on existing contracts. This will eventually lead to fewer purchases, but not right away. Second, account managers may have already been reducing spending in anticipation of the spending cuts. This could have contributed to slower government spending in 4Q12, although it was unlikely to have been the most important factor leading to the contraction of government spending in 4Q12. Finally, government program managers may attempt to delay implementing the cuts in the hopes that Congress will find a way to redistribute them. For example, while some employees may eventually be furloughed as a consequence of the sequester, most departments have not yet given the required 30-day notice of coming furloughs, so any furloughs are at least a month away. While there is substantial uncertainty about the exact timing, which will vary by program and by account manager, it is likely that the cuts will be felt some time in 2Q13 and 3Q13.

Q: How will the sequester affect the economy?

JB: Reducing government spending will have both direct and indirect impacts on GDP in 2013. The direct impact is that a contraction in government demand means fewer purchases of durable goods (especially defense-related) and fewer payments for services. Both of these will show up as a smaller contribution of government spending in the GDP accounts. The indirect impact is a consequence of reduced government outlays leading to lower incomes for workers and businesses, which in turn causes them to reduce their consumption and investment. If policymakers do not take action, the sequester would be a drag of about 0.5 percentage points on GDP growth in 2013, according to estimates from the Congressional Budget Office.

Q: How is the sequester currently reflected in economic forecasts?

JB: Starting in early February, Wall Street economists began assuming that the sequester's cuts would go into effect this year. Currently most economists appear to be assuming that something close to the full impact of the sequester is realized, although a few are still expecting Congress to defer some of the impact.

I think that the risks around the sequester are relatively balanced. On the one hand, the sequester is deeply unpopular with both parties and this suggests a good possibility that the two sides will figure out some way to avoid a significant portion of the cuts. On the other hand, the battle lines are familiar (Republicans committed to no new revenues, Democrats insisting on a balanced approach) and there is no obvious path for quick resolution. To the extent that both sides seem reconciled to the outcome, it is possible they will fail to reach any agreement.

Q: What are the prospects for avoiding a government shutdown in late March? How is that related to the sequester?

JB: Now that the March 1 deadline has been missed, and the sequester is officially in effect, the next deadline facing policymakers is the March 27 expiration of the continuing resolution (CR). The CR is an authorization for spending on discretionary government operations. (The CR is essentially a month-by-month budgeting process, which is currently being used because Congress hasn't passed an annual budget.) Without a CR in place the government is

required to shut down "non-essential" operations. The last time this happened was in 1994 and 1995, when House Speaker Newt Gingrich and President Bill Clinton were unable to agree to a budget and there were two separate government shutdowns. Note that the 1994/95 shutdowns were primarily political events that had very little discernible impact on markets.

Over the past few days both President Barack Obama and House Speaker John Boehner have said that they are committed to avoiding a government shutdown. These statements accurately reflect their political priorities—both Boehner and Obama would likely view a shutdown as damaging to their longer term political goals. The alignment of political priorities makes it likely that they will be able to come to some sort of deal. The most likely deal is that they simply continue authorizing government spending at its current level, and do nothing to address the sequester.

One potential complication is that some policymakers may view the CR as an opportunity to replace the unpopular parts of the sequester. Policy disagreements about how to address the sequester could then lead to a breakdown in talks and eventually cause a government shutdown. While this is a possibility, it seems somewhat unlikely right now.

Q: What are the implications of the sequester for ratings agencies?

JB: The three ratings agencies have indicated that they will review the US credit rating sometime in 2013. They have thus far been waiting on the outcome of the ongoing fiscal negotiations before taking any action, as they would like to base their decision on a more certain picture of the US fiscal path than currently exists. While none of the agencies have given firm deadlines for their decision, it is our expectation that their decisions will come one or two months after the resolution of the current fiscal uncertainty. As discussed above, the current uncertainty is primarily due to the CR, which must be addressed by March 27. Absent some kind of temporary patch, which is always a possibility, we would anticipate a ratings decision could happen sometime in 2Q13 or early 3Q13.

When the ratings agencies evaluate the US credit they will be looking at two things: (1) results, in terms of the projected debt-to-GDP ratio, and (2) the quality of the process by which policymakers made their decisions.

1. **Results:** In terms of the projected debt-to-GDP ratio, the latest CBO estimates suggest that the US is pretty close to having a stable debt-to-GDP ratio through 2023. This fact makes the ratings decision a close call for the agencies. The rating agencies have previously cited a stable debt-to-GDP as a requirement for "fiscal sustainability," and according to this metric, the agencies could plausibly conclude that US finances are on sustainable path over the medium term. The risk to this is that policymakers overturn the sequester. If the sequester is overturned, the debt-to-GDP ratio will be increasing through 2023, and the ratings agencies will be much less likely to conclude the US is on a sustainable fiscal path.

2. **Process:** The ratings agencies have also said that they care about the quality of the process. For example, in early January Fitch said that if the debt limit negotiations were acrimonious and last-minute, then that would cause them to downgrade the US credit. Fitch put out a positive statement following the deal that pushed the debt limit deadline out to August, signaling that they viewed the bipartisan agreement as a positive development. Looking forward, if policymakers force a government shutdown, the ratings agencies would likely view that as negative. However, if they continue their current course of finding bipartisan ways to avoid the larger disasters, even if they are still far short of achieving optimal policies, then the ratings agencies will likely give them credit.

In conclusion, the outlook for the US rating depends on how the negotiations go over the next few months. If the sequester (or some version of the sequester) stays in place and policymakers avoid a government shutdown, then there is a chance that Moody's and Fitch will maintain the AAA credit rating. In my view, this is a close call either way, and very much dependent on events.

Q: What are the implications of the sequester for Federal Reserve (Fed) policy?

JB: The Federal Reserve is very unlikely to change its current monetary policy stance as a result of the sequester. That said, open-ended quantitative easing (QE) and the threshold guidance for future rate hikes were specifically designed so that monetary policy accommodation would automatically adjust to any changes in the economic outlook. Therefore, to the extent that the sequester lowers GDP growth, the Fed will be more likely to extend its purchase program or to push back the date of future tightening, relative to a path in which the sequester was not a drag on GDP growth. The design of the open-ended QE and the threshold guidance means that monetary policy will be dependent on the economic data going forward.

Q: Has the sequester had any implications on the current investment strategy?

JB: The impact of fiscal consolidation is an important part of our outlook for the US economy in 2013. While there are many positive developments in private demand—including an improving housing market and strengthening autos purchases—the impact of higher taxes and lower government spending will be a significant drag on economic growth. This view has been reinforced over the past few weeks, as it now appears more likely that at least some of the sequester will be in effect for the rest of the year.

That said, the US economy appears to be strong enough to absorb these cuts without too much disruption, and accordingly we continue to believe that our credit exposures should fare well in 2013. On the margin, slower economic growth may suggest less upward pressure on US Treasury rates, as investors will continue to value the safe haven status of US Treasuries. Finally, we are monitoring the impacts of the sequester on a company-by-company basis, as cuts to government spending clearly have a disproportionate impact on certain regions and industries.

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